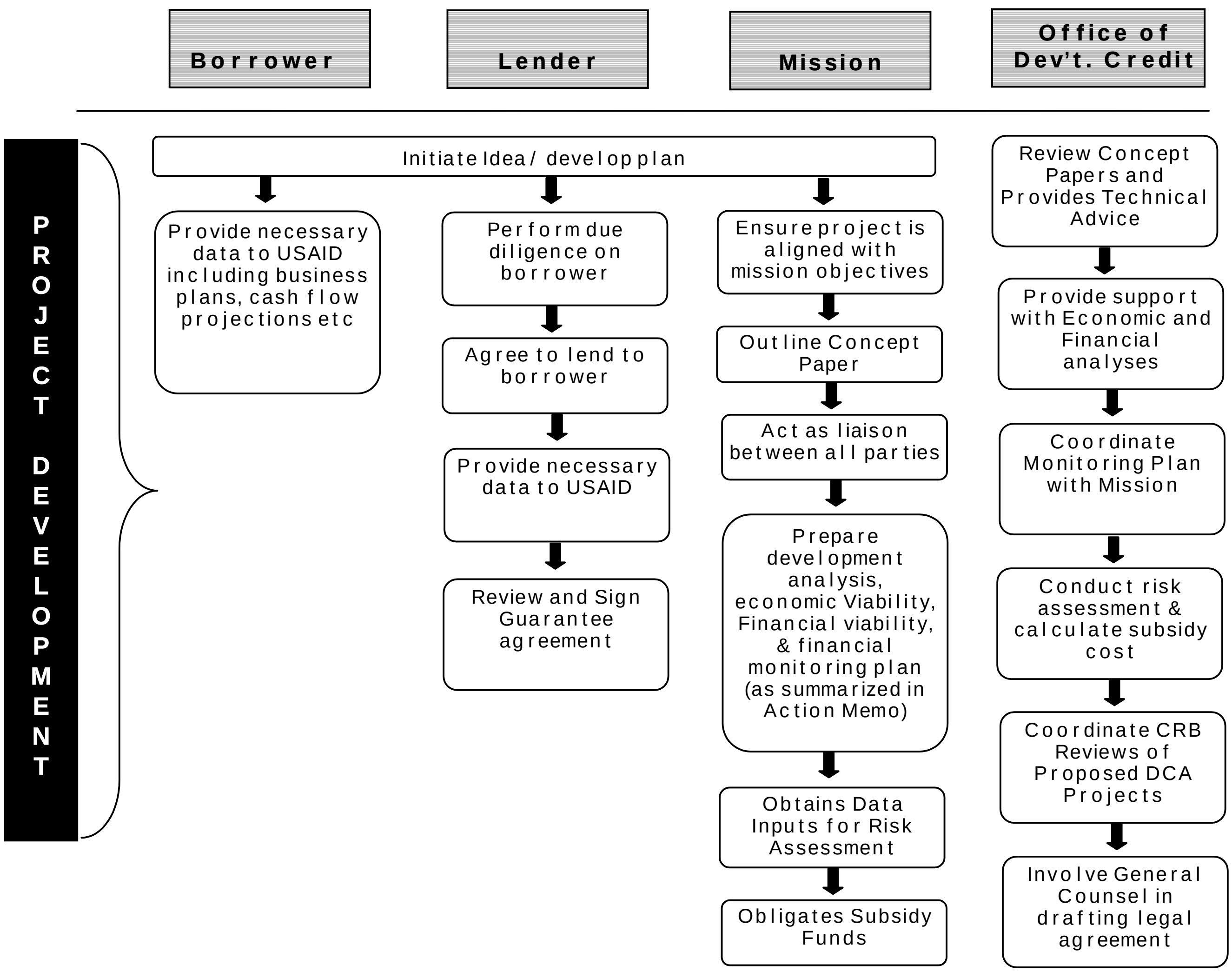
Project Development

The following chart provides an overview of the key actions necessary to develop a DCA project. Essentially, there are four entities that play a major role in project development each with unique responsibilities with the exception of the project initiation step, which can be started by either the borrower, financial institution or the Mission. A subsequent diagram for Project Monitoring is also included in the beginning of a subsequent section of this Manual.

This Project Development diagram depicts a typical DCA loan guarantee structure. Borrowers and lenders, and their respective contributions in developing a DCA project, will vary with other DCA products. In regards to loan portfolio guarantees, borrowers are often neither involved or specifically identified. With a bond guarantee, lenders are potential investors in a municipal or private sector bond issuance. Lastly, in the case of a direct loan, USAID takes on the role of lender.



DCA CONCEPT PAPER OUTLINE

A USAID Mission identifies an opportunity to use credit to support one or more of its strategic objectives and/or ongoing activities. The Mission and USAID Office of Development Credit (ODC) may decide to discuss the idea via email, phone, etc. The Mission prepares a 2-3 page DCA concept paper using the following suggested outline. See Appendix III.A for a sample concept paper.

I. **Description and Purpose of Project**
- Background and Rationale (briefly describe what the Mission proposes to do and why)
- Developmental Importance
- Relationship to Mission Strategy/SOs/Ongoing Activities
- Collaboration with Other Parties, e.g., Donors, NGOs, Contractors, etc.

II. **Structure of Project**
- Financial Intermediary (provide brief background)
- Borrower (provide brief background)
- Intended Beneficiaries (if different from borrower)
- Type of Credit Facility (loan guarantee, bond guarantee, portfolio guarantee, portable loan guarantee)
- Estimated Amount of Project Financing (maximum portfolio size - US$ amount)
- Guarantee Ceiling (maximum USAID contingent liability -US$ amount)
- Guarantee Percentage (%) (covering principal only [preferred] or principal and interest)
- Term of Guarantee (number of years)
- Currency of Guarantee (US$ or local currency)

III. **Funding Source for DCA Credit Subsidy**
- Proposed funding transfers from existing budget resources

IV. **Management Responsibility**
- Initial project monitoring plan
- Clear identification of parties responsible for project development and implementation

V. **Other Funding Available for Technical Support**

VI. **Estimated Time Frame for Project Implementation**

The Mission also indicates to the ODC the amount of Mission resources (OYB – Operating Year Budget) that it is willing to commit to the project. In addition, if ODC considers the proposed project extremely risky (e.g., if the subsidy requirement is extremely high), the Mission might abandon the project at this stage or might engage in efforts toward restructuring the deal to reduce the subsidy cost estimate.

INITIAL REVIEW BY THE OFFICE OF DEVELOPMENT CREDIT

As the concept paper is developed, the Mission is encouraged to communicate with the ODC to obtain technical guidance related to credit tools/projects, taking advantage of the ODC institutional knowledge in order to consider lessons learned from previous DCA projects.

Missions should contact the regional and/or technical bureaus relevant to the project for advice and counsel. It is also possible for the Mission to request funding support from these bureaus if the potential DCA project contributes to strategic objectives of the region or a particular technical area.

If there are a substantial number of project proposals in one particular region, the ODC may elicit the advice of the regional bureau to prioritize projects to most effectively address regional objectives. This will assist the ODC in identifying the project proposals that require significant attention/assistance for further project development.

DETAILED PROJECT DEVELOPMENT

The Mission completes detailed project preparation, including the three required analyses – development, economic viability, and financial viability, along with other necessary project documentation as depicted in the diagram to the right. References to previously drafted work in the Project Proposal are highlighted in the right column of the diagram. For example, the Mission should utilize Section I of its Concept Paper as the basis of the Development Analysis. Similarly, the Monitoring Plan should further elaborate the Concept Paper's Section IV. As needed, the ODC will provide guidance and support to the Mission with project development. As the Mission further develops and summarizes these analyses, the ODC will oversee and advise the Mission on the content and structure of the Action Memorandum prior to submission to the Credit Review Board.

Project Development Checklist
as summarized in the Action Memorandum

	Concept Paper Reference
☑ **Development analysis**	Section I
☑ **Economic Viability analysis**	
☑ **Financial Viability analysis**	
☑ **Financial Monitoring Plan**	Section IV
☑ **Fees Justification**	

Responsibilities of the Mission with oversight from the ODC

Responsibility of the ODC

☑ **Credit Risk Assessment (Subsidy Cost Calculations)**

Development Analysis

The Development Analysis addresses the objective of the activity for developmental soundness – i.e., how the proposed activity supports the Strategic Objectives (SOs) of the Mission. As such, the Mission will review the expected development impacts of the project. A Mission must detail how the activity and its expected outcomes will contribute to the SOs already being pursued or new SOs being developed by the Mission. New intermediate results and indicators may be developed for the proposed DCA activity.

The Mission produces the Development Analysis, as initially drafted in Section I of the Project Proposal, which the Mission Director will approve as part of the overall Action Memorandum submitted to the Credit Review Board. The Development Analysis is not submitted to the Credit Review Board for approval, however it is included in the Action Memorandum for reference purposes. Also, as part of its portfolio management role, the ODC may request progress updates on strategic objectives accomplished as a result of DCA projects. An example of an appropriate Development Analysis is provided as Appendix III.B.

Economic Viability Analysis

The Economic Viability Analysis, which universally applies to all DCA credit products, is the assessment of an activity's impact on the host country's economy. In essence, this analysis justifies the utilization of the DCA guarantee in light of relevant economic and market factors in the context of this proposed activity.

Three specific points should be addressed in the Economic Viability Analysis:

1	The activity will address in-country **market imperfections**
2	The DCA credit instrument **will not supersede private sources of financing**
3	USAID is a **guarantor/lender of last resort** in such a way that the activity would not be possible without DCA

In-country Market Imperfections

This component of the Economic Viability Analysis addresses the overall conditions of the sector impacted by the potential DCA activity. The term 'market imperfections' implies that the supply generated by market participants is insufficient to meet the demands of market customers. The example provided in Appendix III.C involves a DCA guarantee for the energy sector in Brazil. In this case, USAID/Brazil researched significant evidence to demonstrate how the demand for electricity significantly outweighed available supply from public and private sector electricity generation and distribution.

Market imperfections may also refer to specific barriers that discourage or prevent the entry of new approaches, e.g., renewable energy, microenterprises, and municipal infrastructure, into an existing market scheme. A common manifestation of these barriers is limited access to capital, represented by a banking sector's unwillingness to lend to a new approach or a new sector. This unwillingness often stems from a lack of historical references for repayment abilities. In this regard, the Economic Viability Analysis should address how the DCA credit instrument will overcome these barriers, which currently limit market-based lending to the proposed project/sector.

Not Superseding Private Sector Financing

The DCA credit product should not displace the demand for capital and debt financing that could be fulfilled from private sector resources. This can be justified by confirming that the overall commercial banking sector is unwilling or extremely hesitant to lend funds to a particular sector and/or borrower.

Furthermore, the Economic Viability Analysis can indicate if the banking sector charges exorbitant interest rates or requests excessive collateral due to the perception of high risk towards this sector. The Economic Viability Analysis highlights how the use of DCA extends credit to a project based on its actual risks, not its perceived risks. In this sense, DCA intends to be a catalyst, providing demonstration effects, to more properly align the host country financial sector's perception of risk with actual project risks in a certain sector.

Guarantor of Last Resort[11]
Discussions with financial institution representatives related to a DCA proposal should confirm that the DCA guarantee provides an increased level of confidence from their perspective to facilitate the credit to the project. Without the DCA guarantee, financial institutions would be unwilling to lend to the borrower. In other words, the Economic Viability Analysis must provide evidence that the involved or identified financial institution(s) would not extend credit to the activity if it were not for the DCA guarantee. In the case of a portable guarantee, the potential borrower should confirm that DCA will be the unique factor to enable the project/sector to benefit from fair, market-based debt financing.

The Appendix III.C example provides additional support by revealing Brazilian banks' hesitancy to lend to long-term capital projects. The DCA guarantee is perceived as necessary in order to overcome this hesitancy in light of "the absence of a competitive banking industry and other guarantee facilities."

Financial Viability Analysis

The Financial Viability Analysis determines whether the proposed activity will yield a positive financial rate of return. In other words, it will assess the ability of the borrower to meet its monetary obligations and service the debt related to the activity. USAID will only provide credit assistance if the proposed activity generates adequate cash flow to service current and proposed debt. An activity that is not financially sound will not be funded under DCA since the borrowing entity may not be able to meet its financial obligations, including loan principal and interest payments.

Calculating financial viability involves determining the estimated sources and uses of cash required by the activity for successful operations. Viable activities are characterized by sufficient projected cash inflows to pay for planned expenditures. Once the cost and revenue streams have been estimated for the life of the activity, the outflows and inflows are compared to determine whether the proposed activity generates adequate cash to meet anticipated expenditures.

The first step of a Financial Viability Analysis is the forecasting of cash flows.

Single Borrower (e.g., Loan Guarantee). In the case of guarantees provided for a single project, i.e. loan guarantees, portable guarantees, and some bond guarantees, future cash flows reflect the operating revenues and expenditures relevant to a particular project. If a private sector business or municipal corporation is involved, the Mission should collect or assist in obtaining three years of audited financial statements, as well as forecasted balance sheets, income statements and cash flows statements. Based on ODC guidance and assistance, the Mission should review these forecasts for realistic assumptions in comparison to audited historical figures for the entity.

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11 "Lender of Last Resort" in the case of a direct loan.

Multiple Borrowers (e.g., Loan Portfolio Guarantees). For a loan portfolio guarantee or a bond guarantee supporting many different projects, the Mission should provide forecasted cash flows for at least two representative projects that will receive funding guaranteed by DCA. Alternatively, if representative projects are not appropriate or applicable, e.g. mortgage-based lending, notional cash flows should be produced. All forecasts should be checked thoroughly to ensure that conservative and realistic assumptions are utilized, especially in terms of 1.) the base level (i.e. Year 0 or Year 1) and 2.) the projected growth of revenues and expenses.

The following diagram shows a simplified overview of how the Mission, with ODC guidance, should perceive cash flows for the Financial Viability Analysis. "Operating Cash Flow" is the key figure that should be compared with financing costs, i.e. the existing and future principal and interest costs for loans/bonds. Further details and more comprehensive explanations of cash flows are provided in Appendix III.D.

OPERATING CASH FLOW COMPONENTS

- Revenues (less cash-related operating expenses)
- Increases/decreases in short-term balance sheet accounts
- Expenditures on equipment

Forecasted for the project life or the relevant term of the DCA credit tool

With the forecasted cash flows as a basis, the Mission should calculate two indicators to complete a Financial Viability Analysis: the Net Present Value and the Internal Rate of Return.[12]

1	**Net Present Value (NPV)**: DCA projects must demonstrate a positive NPV, which is the present value of all cash outflows (investments) and inflows (returns) of a project at a given interest (discount) rate. Since the streams of expenditures and receipts occur over a period of time, they are discounted to account for the time 'value of money',[13] using the market interest rate or the financial cost of capital to the borrowing entity. When conducting a NPV analysis, the selection criterion is to accept DCA activities with a NPV greater than zero.
2	**Internal Rate of Return (IRR)**: Another measure of financial viability is the IRR. IRR is the interest (or discount) rate at which the present value of an investment in a project is zero. When this IRR exceeds the prevailing interest rate, the project is deemed to be an attractive investment.

Lastly, the NPV and IRR analyses should include projections for several scenarios from a 'best case' (i.e. revenues exceed expectations and/or costs are below expectations) to a 'worst case' (i.e. revenues do not meet expectations and actual costs are higher than forecasted costs). The parameters of the scenarios should range from 5-10 percent of the forecasted revenue and expense data. This **sensitivity analysis** is fundamental to assess the viability of the project in case the forecasted cash flows do not accurately predict how the actual operations will occur.

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[12] Technically, the IRR and NPV analysis will provide the same answer regarding a project's financial viability. For calculation assistance, IRR and NPV are built-in financial functions to most spreadsheet software programs, such as Microsoft Excel.

[13] The basic premise of the 'time value of money' is that a dollar today is worth more than a dollar tomorrow due to the interest earned on today's dollar. Data should be considered in nominal terms, which include inflation.

An example of a Financial Viability Analysis is provided as Appendix III.D. The format of this example, which highlights cash flows from operations, investments and financing, provides much more detail than the generic diagram on the previous page. However, the cash flows analyzed represent the same overall approach. Also, Appendix III.D provides an outline of the typical components of this analysis.

If the Mission needs assistance with this analysis, it should contact the ODC. This will most likely be necessary in the case of project or bond financing. Please consult with the ODC for guidance from the initial stage of these DCA project types.

Regardless of the level of ODC support, the Mission will lead efforts to gather information commonly required for DCA supported projects. In the case of a project-specific DCA structure, required inputs for the Financial Viability Analysis will include:

- Project start-up costs
- Future income generated by the project
- Estimated operating and maintenance costs
- Local interest rates (debt servicing costs), tax expenses, etc.

As stated previously, for a portfolio guarantee, illustrative examples of a few borrowers or notional cash flows will be necessary to demonstrate a model for how the debt will be repaid. This model should contain data inputs as just listed for project-specific structures.

If the borrower is an existing organization, the Mission should, at a minimum, collect audited financial statements from the last three years, as well as any forecasts the entity has prepared for the near term future. These documents should include:

- Balance Sheet (assets, liabilities and equity components)
- Income Statement (revenues, operating expenses, financing expenses, net income)
- Cash Flow Statement (cash flows from operations, from investing, and from financing)
- Sources and Uses of Funds

Regardless of the level of ODC involvement, the Mission will submit the Financial Viability Analysis to the ODC for final review and approval.

Financial Monitoring Plan

With oversight from the Office of Development Credit, the Mission must demonstrate that they have the capacity and necessary resources to ensure careful monitoring of a DCA activity. As part of the approval process, the Credit Review Board will examine the Financial Monitoring Plan to ensure that the Mission and the ODC will adequately respond to problematic issues as they arise related to borrowers and or lenders involved in a DCA transaction. The typical components of a Financial Monitoring Plan include:

- Designation of Mission staff member(s) responsible for follow-up on the timely collection of reports and communications with the ODC. Staff members can include direct hires, host country nationals and contracted staff.

- Specific collection activity requirements and time horizons (e.g., semiannual or quarterly communications with the ODC to verify reporting and fee compliance, as well as utilization data; and biennial (once every two years) site visits by the Mission and ODC.
- Schedule/calendar of activity deadlines.
- Annual estimates of administrative costs for monitoring activities. This is calculated by converting the time forecasted for the allocations of staff member(s)' time by the relevant salaries of this personnel.

More information related to monitoring is provided in the Project Monitoring section of this Manual. Also, a sample Financial Monitoring Plan is included as Appendix III.E.

Fees Justification

Appendix III.F provides a sample of the brief (1-2 pages) Fees Justification that is currently required as a DCA Action Memorandum attachment. This example demonstrates how the Mission, in conjunction with the ODC, determined the commitment (origination) and utilization fee percentages. As highlighted in the 'Common Attributes of DCA Products' section of this Manual, both of these fees have a minimum limit of 0.25%. Appendix III.F also presents a section of the ADS to further explain the factors that affect a fee structure and the possible exceptions to DCA fee standards.

CREDIT RISK ASSESSMENT

The ODC will coordinate with the Mission when and how the credit risk assessment will be conducted following significant activities completed in the 'Detailed Project Development' phase (see previous section).

The risk assessment is an analysis performed on the country, lender, borrower, and structure of a credit activity to evaluate the creditworthiness of a particular DCA credit transaction. The analysis determines the probability of adverse outcomes, or default – the higher the level of risk, the greater the probability of negative cash flows and resulting loss to the U.S. Government. The expected cost to the U.S. Government of a credit transaction is called a ***subsidy***. For all credit activities, USAID sets aside a subsidy, which acts as a loss reserve, in a holding account for the duration of the specific deal. The subsidy is the net present value of all credit-related cash outflows and inflows to the U.S. Government.

Notwithstanding the availability of ratings from a noteworthy credit rating agency, credit risk will be assessed and scored according to guidelines of the *USAID Credit Risk Assessment Handbook*. This document details the steps to follow for a risk assessment. For more information on the credit risk assessment, contact the Credit Supervisory Officer at the USAID Office of Development Credit.

Although the ODC performs the risk assessment, the Mission and participating institutions in a DCA transaction support this aspect of project development with information research and collection. Although this information gathering will vary depending on the credit activity, it typically includes: audited financial statements for 3-5 years, business/strategic planning documents, CVs of key personnel, financial projections, human resources information, policies/procedures, organization charts, etc. Based on these inputs, the ODC staff and/or contractors will conduct the risk assessment to ensure an independent analysis of project risk related to the possible outflow of U.S. Government funds.

A brief overview of factors assessed in a DCA risk assessment are summarized as follows:

- **Country Risk**: Country risk, which typically accounts for 40 percent of the risk assessment, is determined by a rating system used throughout the U.S. Government. This system, the Inter-Agency Country Risk Assessment System (ICRAS), takes into account such factors as foreign exchange conditions, banking and legal systems and the overall business climate.
- **Borrower Risk**: Borrower risk, normally 20 to 40 percent of the risk evaluation, measures the ability of the borrower to pay back the lender. Although the risk components vary with the type of borrower and the nature of the transaction, common factors to analyze include both borrower-specific factors, such as financial strength and management quality, and external factors, such as industry, market and regulatory environment. The *USAID Credit Risk Assessment Handbook* outlines how to assess borrower risk for six types of entities: private sector business, financial institution, microfinance institution, private voluntary organization, and a utility/infrastructure project financing and general obligation structure.
- **Lender Risk** (for guarantees only): Lender risk, also accounts for 20 to 40 percent of the risk score, and it assesses the lending institution's experience and ability to originate and monitor loans. If a typical commercial banking institution is the lender, USAID utilizes a widely accepted "CAMELS" analysis to evaluate the bank's **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market factors.
- **Transaction Risk**: Representing 5 to 20 percent of the risk score, the transaction risk component considers factors related to the deal structure, such as collateral, escrow accounts, third-party guarantees, and the diversification of risk with a portfolio of dissimilar borrowers.

Based on the risk assessment, the ODC finalizes the subsidy cost of the DCA transaction, which is included in the action memorandum to be reviewed by the USAID Credit Review Board (CRB) and approved by the USAID Chief Financial Officer (CFO).

PREPARATION OF ACTION MEMORANDUM

The Action Memorandum serves as the key documentation vehicle for the DCA activity in the project development phase. Following is an outline for the document:

ACTION MEMORANDUM

To: **USAID CFO**
Through **Credit Review Board**
From: **Mission Director**
Date: **XXX**
Subject: **[Loan, Portfolio, Bond, etc.] DCA Guarantee**
Project Name

Attachments:
(1) Development Analysis
(2) Economic Viability Analysis
(3) Financial Viability Analysis
(4) Risk Assessment
(5) Financial Monitoring Plan
(6) Fee Justification
(7) Subsidy Calculation

ACTION REQUESTED: (a) To evaluate the appropriateness of DCA credit assistance as a financial tool to support the Strategic Objectives (SO) of USAID/[country] relating to [description of SO] and (b) to approve the subsidy cost for the proposed activity.

SUMMARY: Concise synopsis of pertinent facts related to the proposed project.

DESCRIPTION OF THE PROPOSED PROJECT ACTIVITY: Short summary of background of the project and the attachments listed above. In addition, a table detailing the terms of the agreement should be included as shown below:

Structure of the Guarantee (Credit Terms)

Guaranteed Parties	**[Name of financial institution]**
Type of Guarantee	**[Bond, loan, loan portfolio] Guarantee**
Authorized Amount	**[Foreign currency] equivalent of US$XXX**
Guarantee Ceiling	**US$XXX**
Level of Guarantee Coverage	**XX%**
Term	**XX years**
Fees: Origination Utilization	 **XX% of guaranteed amount** **XX% of guaranteed amount**
Currency	**[Foreign currency]**

RECOMMENDATION: That you approve this request to utilize $XXX from the FYXXXX DCA appropriation to support the DCA credit instrument as described above.

(signatures)
Approved: ____________________________
Disapproved: ____________________________
Date: ____________________________

CLEARANCE PAGE FOR ACTION MEMORANDUM requesting approval of DCA credit subsidy calculation and authorization to provide a DCA loan portfolio guarantee.

CREDIT REVIEW BOARD (CRB) & CHIEF FINANCIAL OFFICER (CFO) APPROVAL

Prior to submission of the Action Memorandum to the CRB for review, the Office of Development Credit will review the document and work with the Mission to finalize its contents, including the subsidy calculations.

The CRB will evaluate the entire proposed DCA activity to ensure that:

- The activity is financially viable
- The activity is economically viable
- The risk assessment and subsidy calculation are correct
- The Mission is prepared to financially monitor this activity based on staff time and expense estimates

Based on the CRB review, the ODC may request that the Mission perform further activity development. Otherwise, the CRB will recommend the subsidy cost calculation to the CFO for approval.

The CFO, upon a positive recommendation from the CRB, reviews and approves the subsidy cost calculation, and verifies that the allocated transfer authority is within the existing ceiling. The CFO notifies the ODC immediately of the outcome, which in turn notifies the Mission.

CONGRESSIONAL NOTIFICATION & FUNDING TRANSFER

The Mission then decides to continue with DCA activity based on CFO approval of the Action Memorandum. If approved, the Mission prepares a Congressional Notification (CN), submits it to its Regional Bureau, which then reviews and sends the document to USAID Bureau of Legislative and Public Affairs for submittal to the U.S. Congress. A CN example is provided as Appendix III.G.

Once the 15-day CN waiting period has expired without Congressional objection, the Mission Controller or Program Officer requests that the regional bureau controller or program officer transfer an appropriate amount of Mission funds from the Development Assistance (DA) account or Economic Support Fund (ESF) to the DCA Account.

Generally, the transfer of funds to the DCA Account follows these steps:

- The Bureau of Policy, Program and Coordination (PPC) makes an appropriate reduction of the funds allowed to the Mission, thus regaining USAID/Washington's control of the necessary funds.
- PPC in conjunction with the Regional Bureau sends a request to the U.S. Office of Management and Budget (OMB) and Treasury to reduce the budget authority level in the relevant appropriation account, and to increase, by the commensurate amount, the budget authority level of the DCA Account.
- OMB makes the apportionment of DCA Account budget authority to USAID.

- In conjunction with the Office of Financial Management,[14] PPC makes an allowance of the DCA budget authority to the Regional Bureau.
- The Regional Bureau sends an email regarding the allowance of the funds to the Mission. The email provides a funding citation to enable the Mission Controller to enter the funding in the Mission accounting system.

At this point, the transfer has been executed and the funds are back under the control of the Mission. The Mission Controller can now certify the availability of sufficient DCA budget authority to permit the legal obligation.

PROJECT AGREEMENTS SIGNED & FINANCIAL CLOSING

Borrowers and/or lenders will then sign the loan, or loan guarantee, agreement(s). The General Counsel's Office and its Regional Legal Advisors (RLAs) will coordinate the drafting of these legal documents. Missions should consult their RLAs throughout the development, negotiation, and implementation of a DCA project. The Mission obligates the funds immediately after financial closing and notifies the Office of Development Credit that the subsidy is obligated by email/facsimile and by sending a copy of the signed obligating document. ODC then provides a signed copy of this document to FM/LM. The DCA activity implementation and monitoring then begins.

[14] Specifically, the Office of Financial Management, Central Accounting and Reporting Division, Funds Control.